RUBRICS

Macro Overview

High Stakes Dilemma

Fixed Income Macro View

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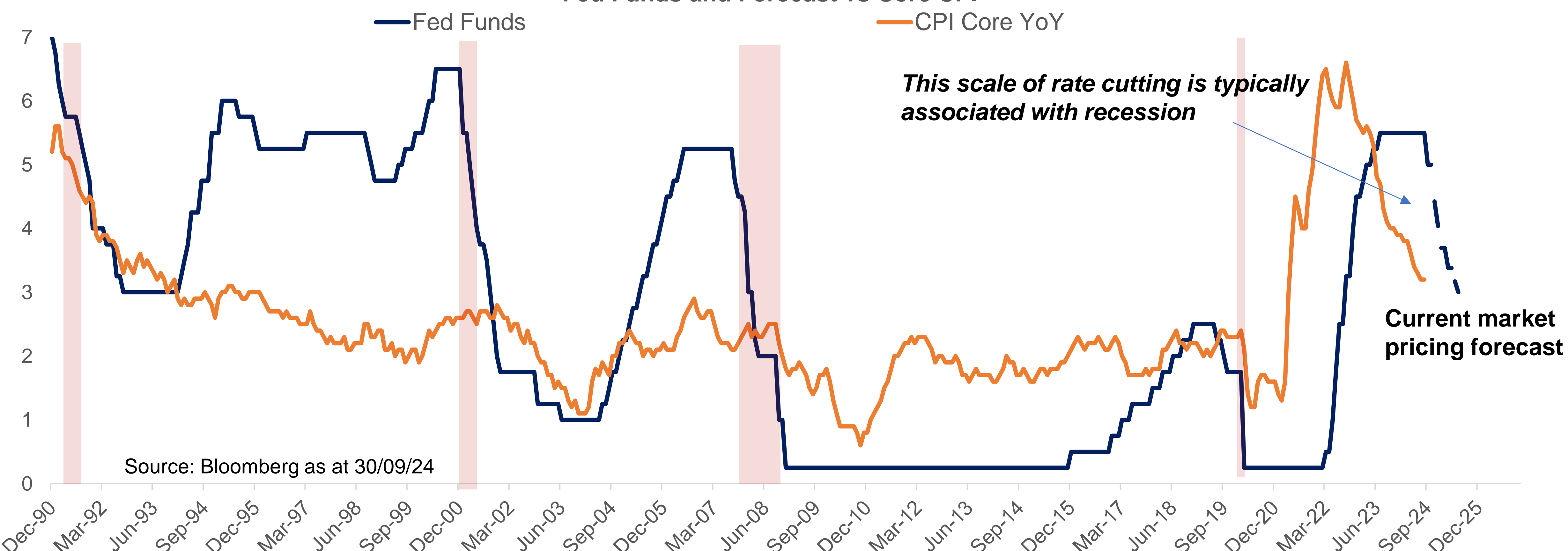
Summary

- **An aggressive Fed cutting cycle in a period of positive economic growth, asset prices at all-time highs and a near record fiscal deficit has never been done before. At the same time, two and a half years since rate rises began, the economy is starting to show signs of weakness. What to do?**
- **Fiscal dominance changes the game. Market pricing of a 'goldilocks' outcome of robust growth *and* benign inflation is extremely optimistic – risk assets will need to readjust**
- **Fixed income can offer value – most notably in a hard landing/recessionary scenario or in a "no landing" outcome via higher carry potential in the shorter end of the yield curve**

High Stakes Dilemma

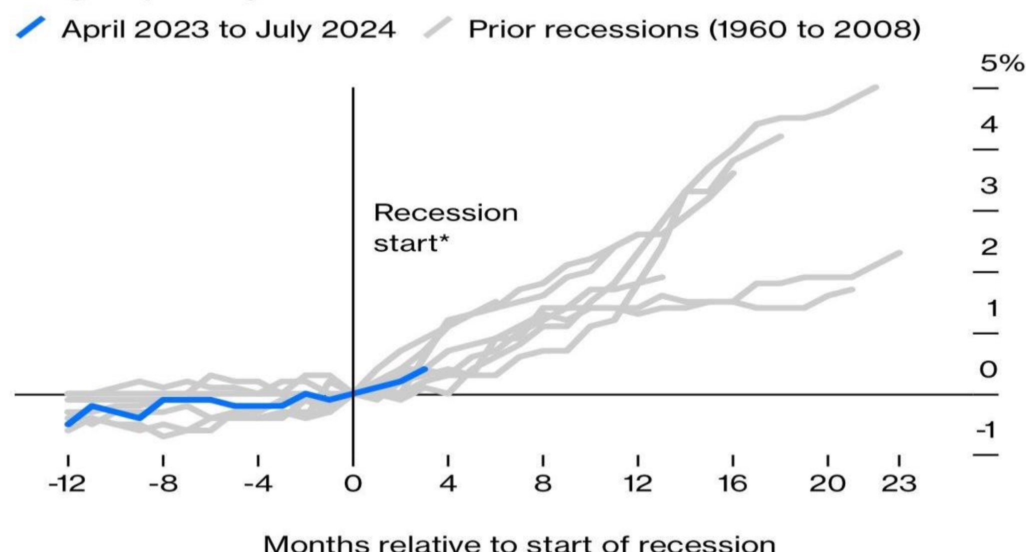
The Star Trek fans among us will no doubt be familiar with the Kobayashi Moru, a "no win" scenario training exercise designed to test performance under the most trying of circumstances. The decision facing an up-and-coming captain was whether to rescue a stranded civilian vessel (named the Kobayashi Moru), knowing that to do so would endanger the lives of his/her crew, or leave them to perish at the hands of the dreaded Klingons. A fitting metaphor for the current predicament in which Central Bank find themselves? Cut hard and fast and the jobs market (economy) is saved. Ease too aggressively and risk inflation re-igniting. There's no doubt the Fed is in quite a pickle. Their increasing reliance on data dependence, the variation in the dot plots and the first dissent by a Fed governnor since 2005 suggests the dilemma is not lost on them. What about a soft landing? Even if a recession is avoided (a fairly big if), with the fiscal deficit set to exceed current bloated levels, the likelihood of a benign inflationary outcome is very unlikely in our view despite what financial markets have priced it in. We highlight below some of the factors we think are both supportive of aggressive Fed easing and others that might caution against this approach. If you manage to make it to the end, we briefly summarise what it might mean for investors in the short to medium term (with our fixed income hat very much on).



Rubrics Fixed Income Macro View

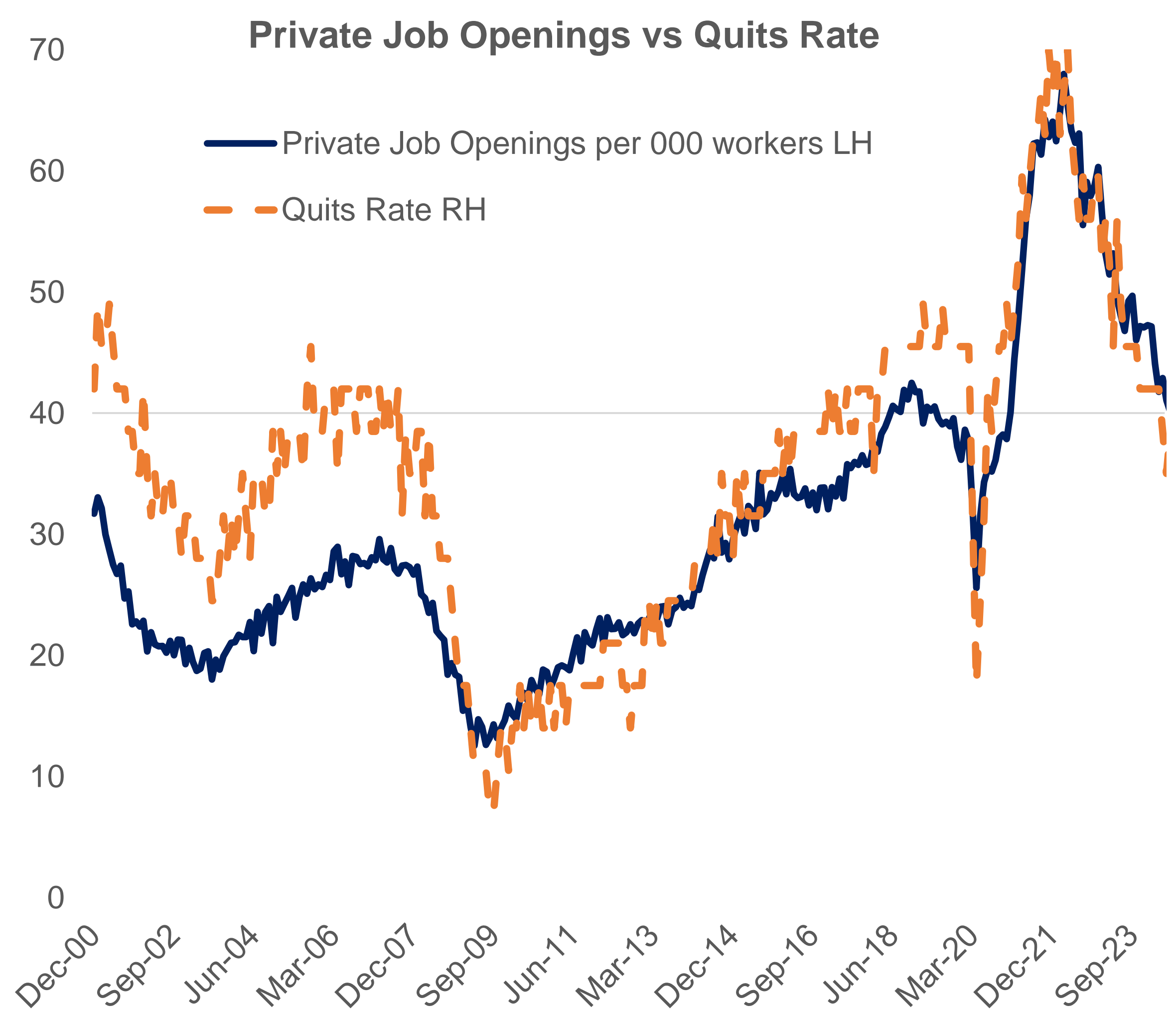
27th September 2024

Reasons to be Aggressive	Reasons to be Cautious
Labour Market	**Structural Inflationary Forces**
(Leveraged) Consumer	**Asset Prices**
Global Growth Backdrop	**Fiscal Concerns**
Shadow Banking	
Fiscal Concerns	

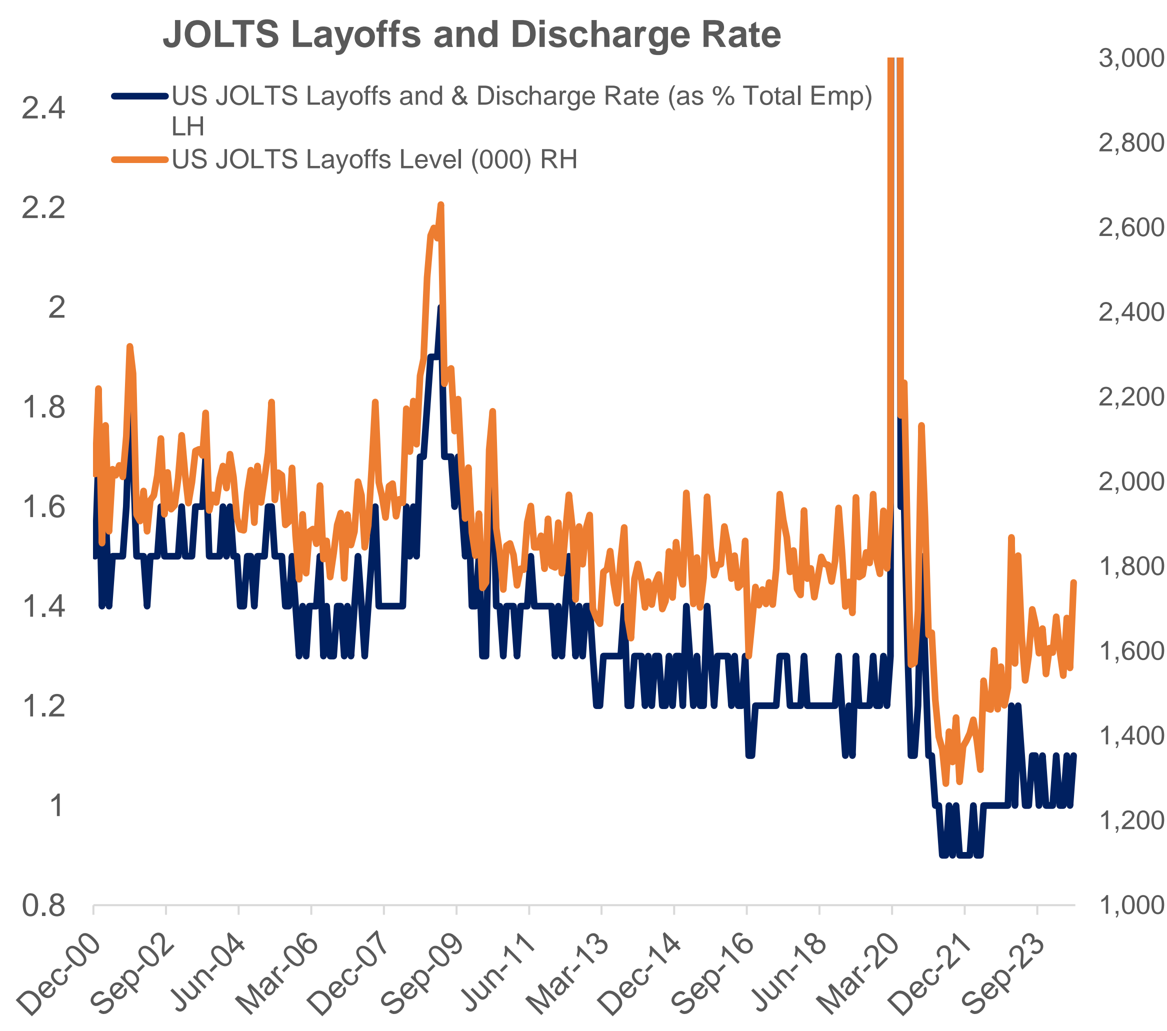


Reasons to be Aggressive

Labour Market - The triggering of the Sahm Rule over the summer shook market confidence in the Fed achieving their much-coveted soft landing. The rule itself highlights an interesting property of unemployment - namely the reflexivity of the labour market. Once a certain threshold is hit (3 month moving avg of UE > prior 12 month low), the floodgates typically open to significant further job losses, with nothing in between. Why? Reflexivity. When employment declines it hurts confidence and spending which hits revenues and triggers further job losses. While Claudia Sahm herself has talked down the efficacy of her indicator in relation to the current triggering (the rise in unemployment is largely due to increases in the labour force not actual job losses) the Fed are acutely aware of the negative feedback loop that can take hold in the labour market. Although headline numbers are not yet sending a dire warning there are plenty of data points that do paint an increasingly concerning picture. Can the Fed pre-empt an employment recession?

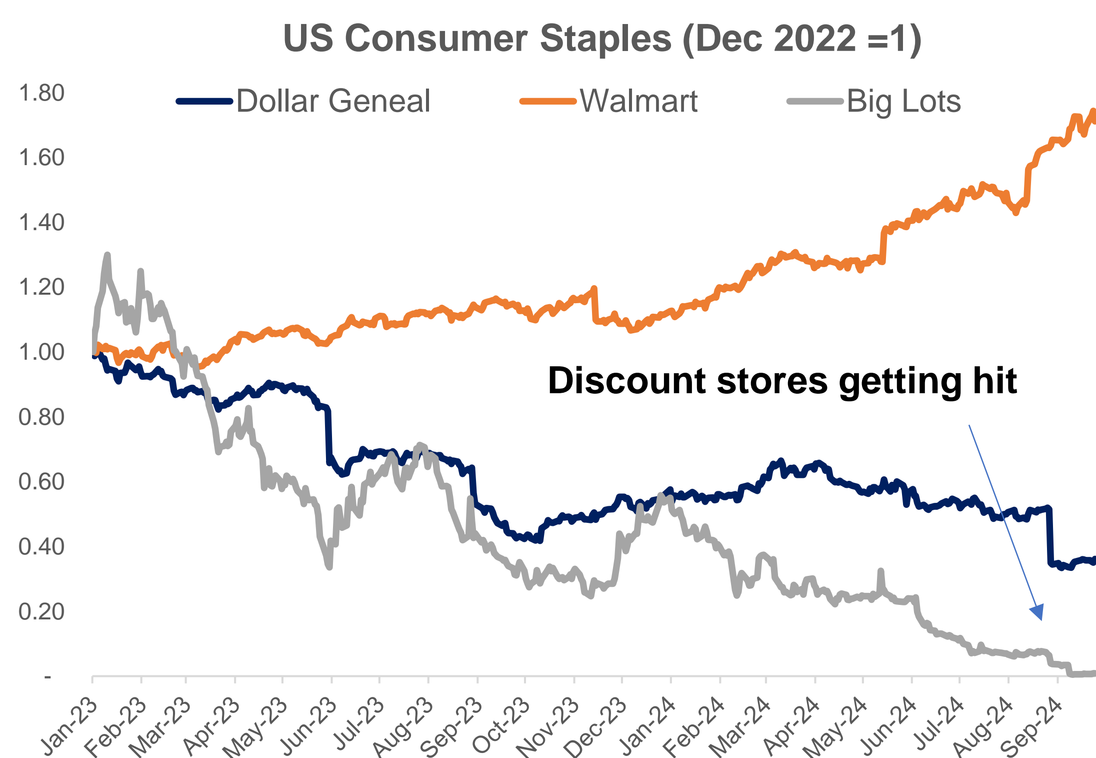


Source: Bloomberg as at 31/08/24

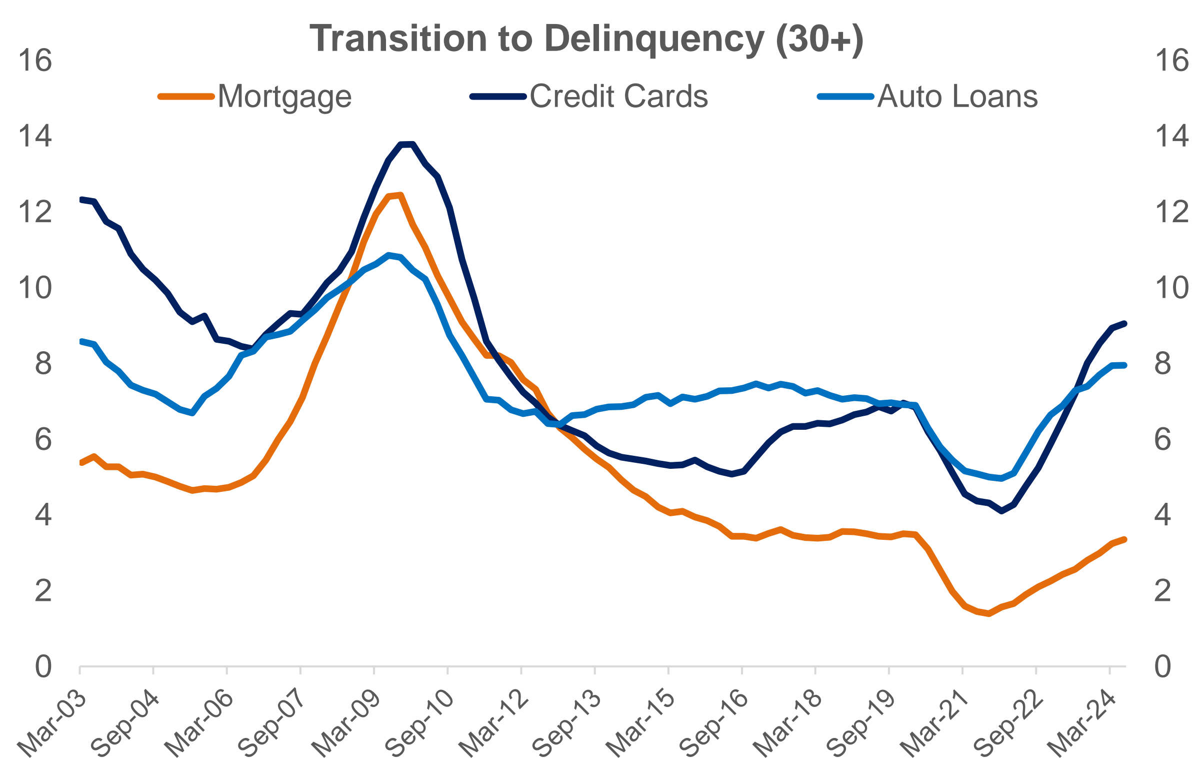


Source: Bloomberg as at 31/08/24

(Leveraged) Consumer - Much has been made of the strength of the US consumer post COVID with plenty of data still suggesting a robust backdrop. A clear dichotomy exists however between the haves and the have nots. As has been well highlighted, higher rates have not had much of an impact on the top income quartiles of the economy. Most own their homes at locked in low mortgage rates, have not lost their job and benefit from financial asset prices at record highs. For those in the bottom income quartile however, life is not so good. They don't own a house, spend everything they earn on heavily inflated essentials (food, rent) and unlike their wealthier counterparts are subject to higher interest rates on credit card debt, auto loans, etc. While this bottom cohort are often dismissed in terms of their contribution to overall consumption (<10%), it is likely the case that continued weakness would eventually work its way higher up the income ladder through a combination of increased delinquencies and broadening demand destruction.

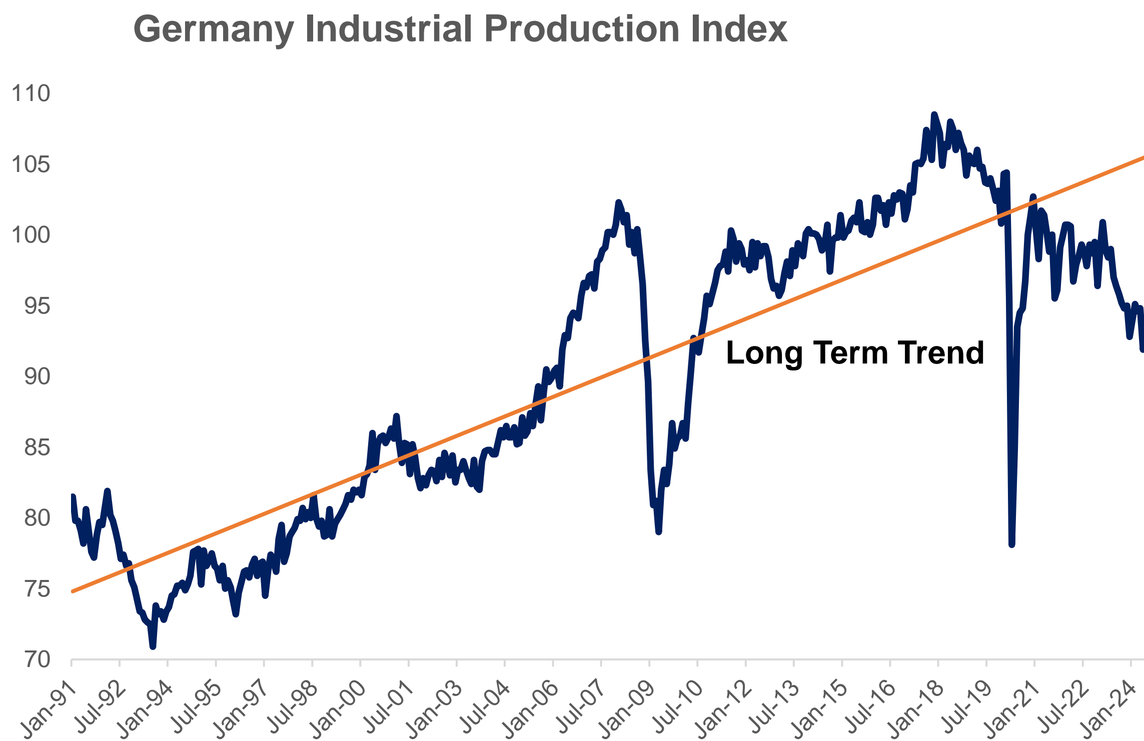


Source: Bloomberg as at 25/09/24

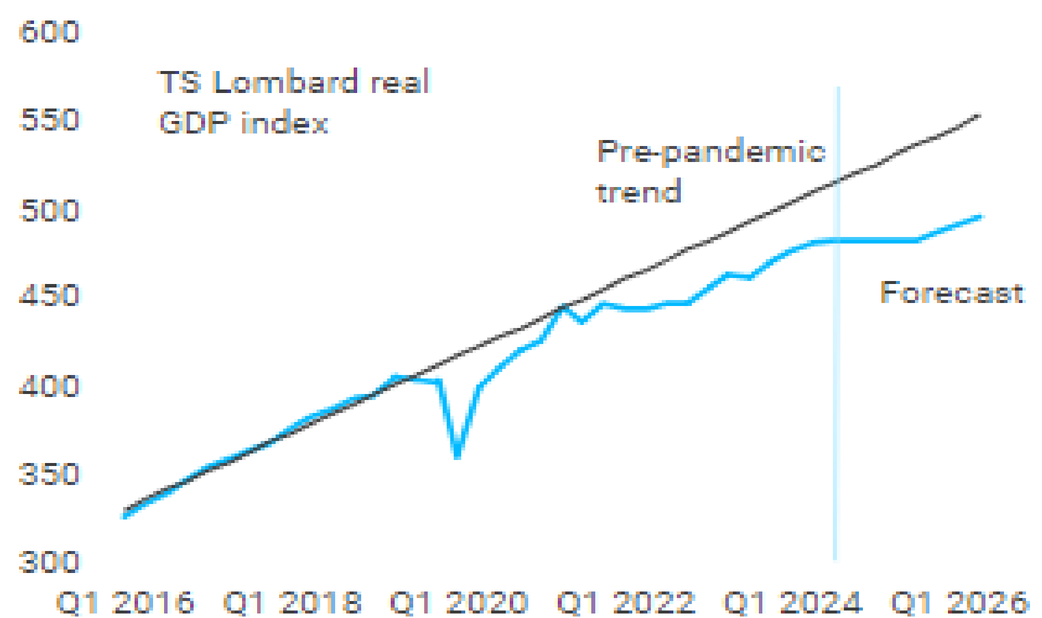


Source: Bloomberg as at 31/08/24

Global Growth Backdrop – The notable weakness of manufacturing relative to services is likely in part reflective of the challenging global backdrop. In this, China and Germany are very much front and centre of a deteriorating global growth picture. Although recent interventions from the PBoC have been greeted with a fair degree of optimism, the fact remains that China is mired in a balance sheet recession where no amount of rate cutting and liquidity alone can spur a meaningful increase in demand. What is needed to course correct the alarming decline in the growth trajectory is more akin to a US style TARP programme for the banking sector - which would likely need to be in the order of $1trln plus, not in the hundreds of $blns. Increasing social unrest driven by falling growth may yet provide the catalyst for action, but one suspects it will take time for the economy to emerge from its slump. While the Fed is ostensibly concerned with domestic US matters, they will be very aware of the malaise affecting the economy that - let's not forget - contributes more than 20% to Global GDP growth. A weaker USD can provide a much-needed window for the PBoC to alleviate some of the short-term pain, while in addition may provide some support for US exporters against a backdrop of weaker global demand.

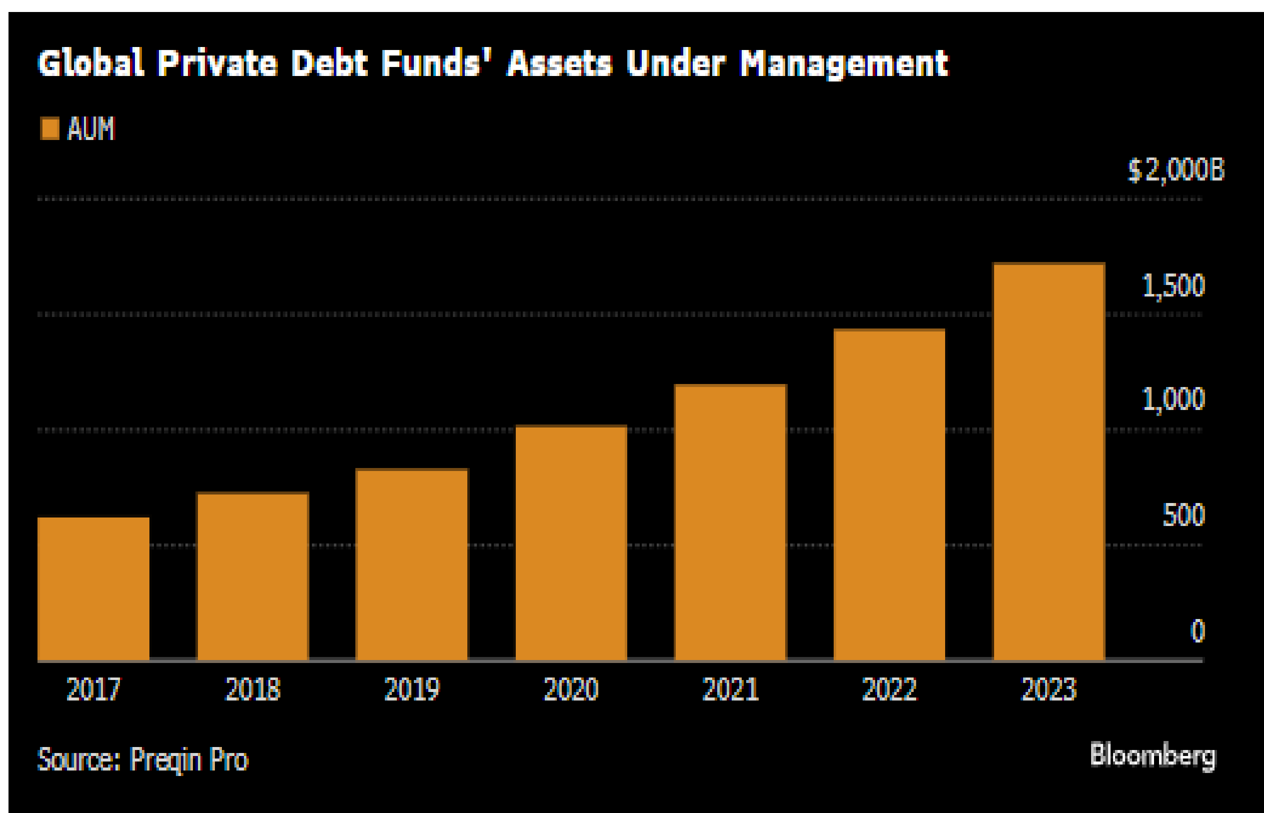


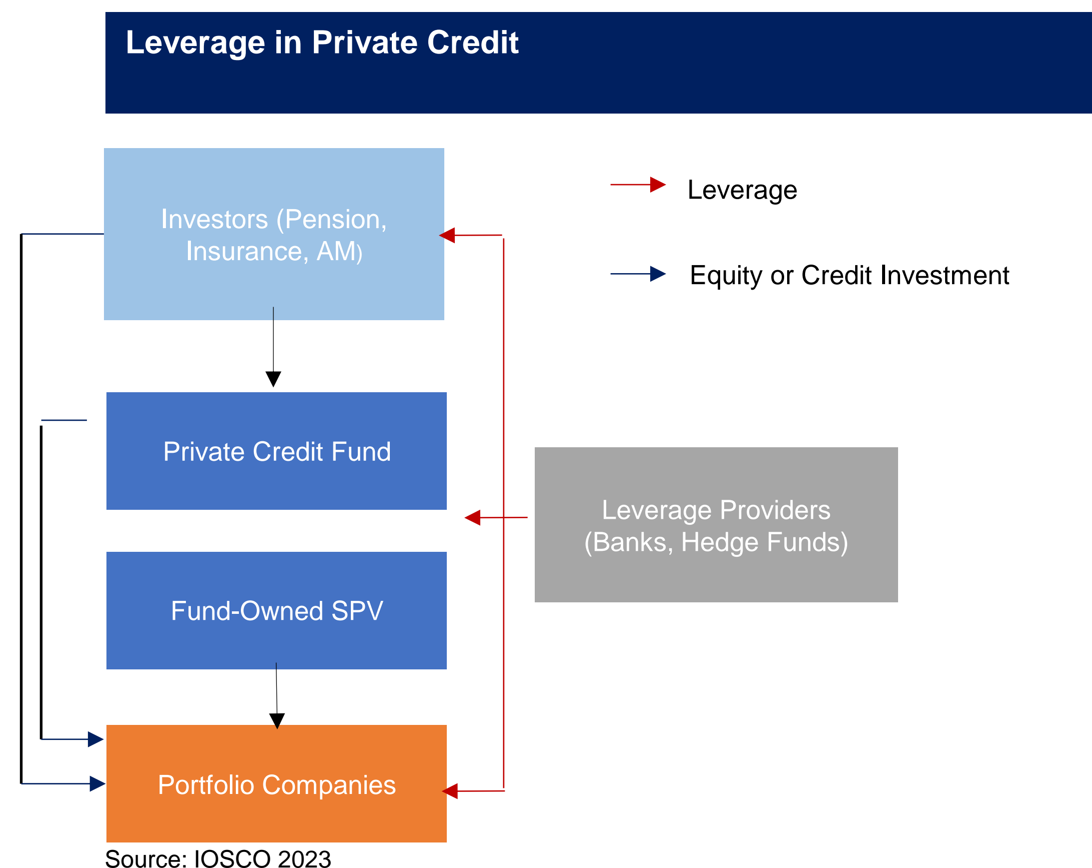
Source: Bloomberg as at 31/08/24



Source: GlobalData TS Lombard, Datastream, CEIC

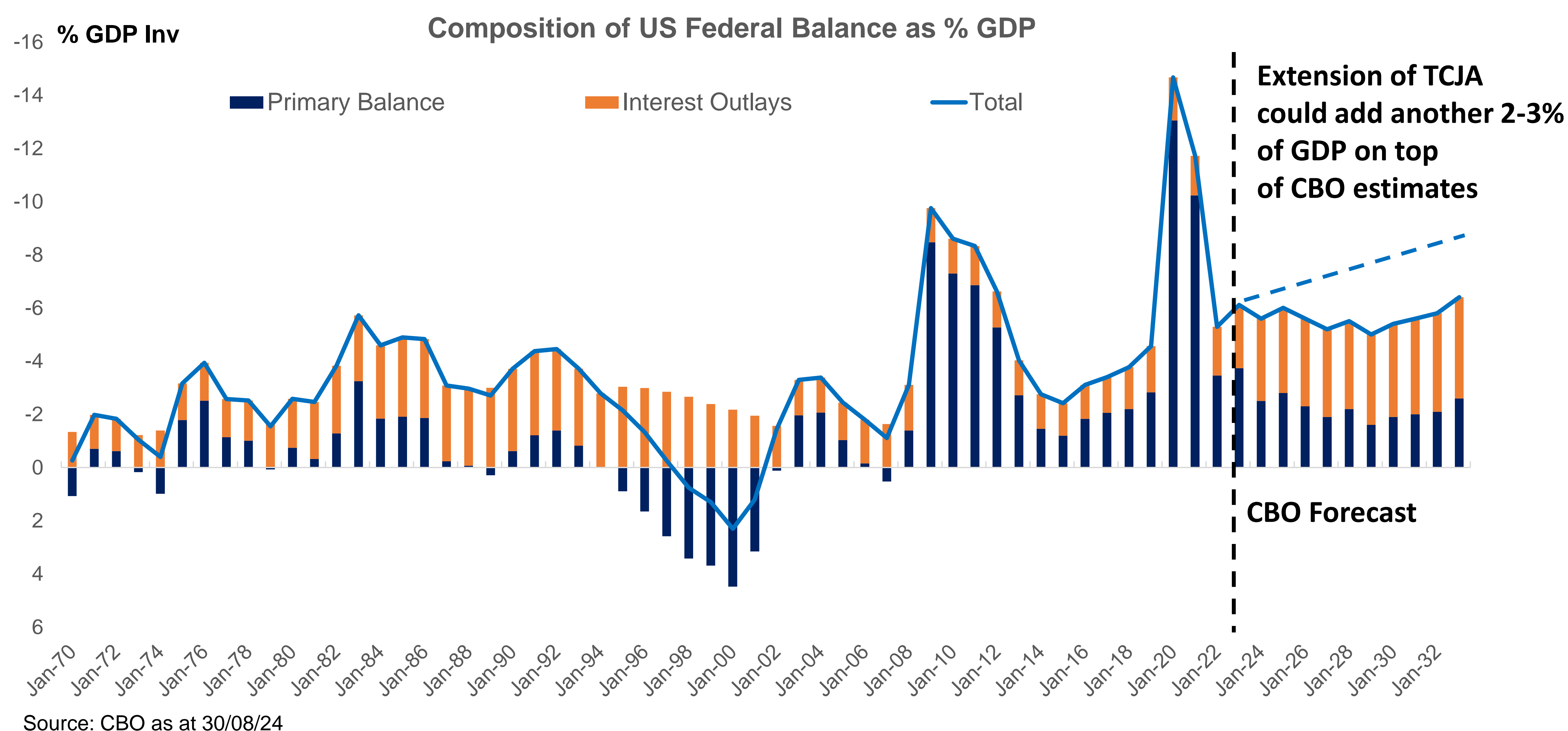
Shadow Banking - The rise of private credit is gaining increasing traction amongst both financial market participants and global regulators. As banks have stepped away from riskier lending post GFC, Private Credit has stepped into the breach to provide funding to lower quality borrowers who either cannot or choose not to tap the bond or loan markets. From a regulatory perspective this has been a positive as risk has been diversified away from the systemically important banking sector to the broader institutional asset management industry. The proliferation of assets into the shadow banking sector does however create a number of new headaches. Primarily from a supervisory perspective, the lack of transparency into the underlying assets in terms of valuations, leverage and liquidity make oversight increasingly difficult. With much of the underlying debt of a floating rate nature on companies in the B/B- area in terms of credit quality, higher rates should be having an impact on solvency. The fact that the market has grown by over $1trillion in the last 5 years also makes it too big to ignore. Banks continue to get in on the act by providing of leverage to the broader eco system while the pension and insurance industries have the bulk of the exposure. The bottom line is the Fed will not want a blow up on their watch and will be keen to ensure the refinancing (flows) channel remains open. Any form of dovish Fed sentiment will be cheered loudly by those in the private market space.





Source: IOSCO 2023

Fiscal Concerns - The eye-watering fiscal deficit projection from the CBO should be causing plenty of sleepless nights amongst policy makers and financial markets participants. One suspects however that the combined efforts of the Fed and Treasury last summer in effectively monetising the US deficit have gone some way to assuaging fears in the short-term at least. Nevertheless the annual interest cost on US government debt is set to grow exponentially higher and perhaps more worryingly neither Trump or Harris intend on doing anything to address it. Notwithstanding longer term concerns over the demand for US Treasuries (more on this later), in the here and now there is an (admittedly simplistic) argument to be made for lower rates in the name of reducing the crippling interest burden on US debt.

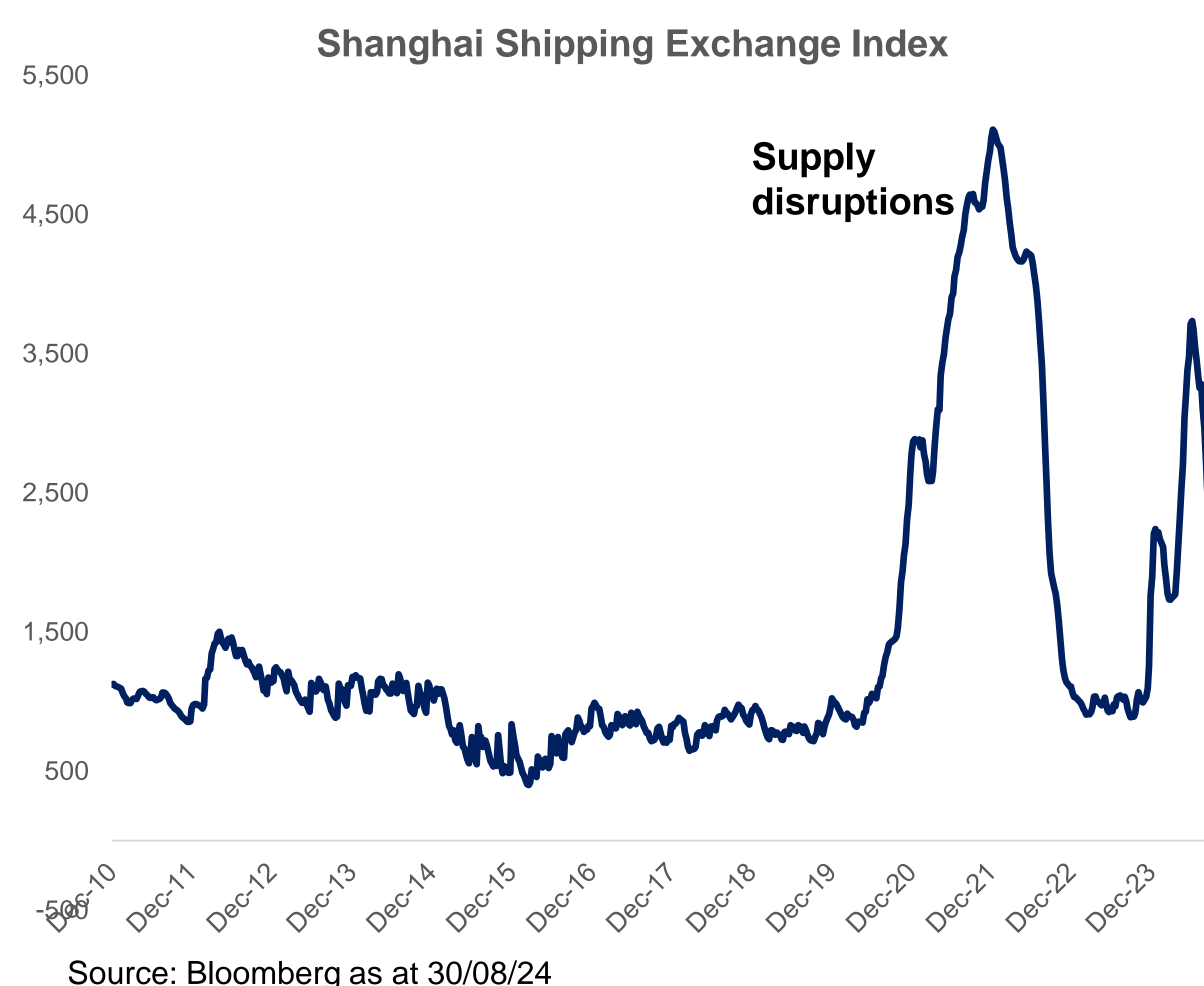


Source: CBO as at 30/08/24

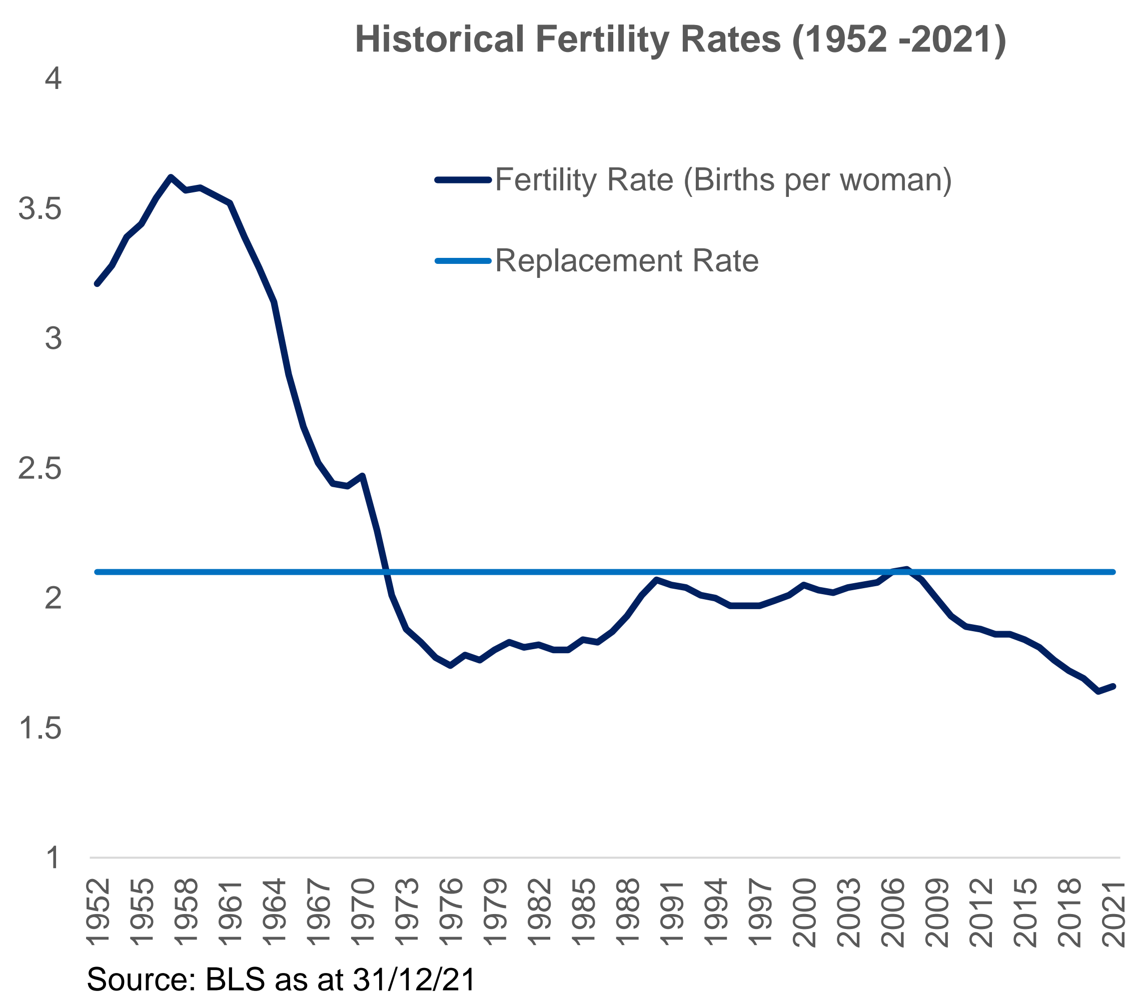
When tied together, there are a growing number of supporting factors for the Fed's decision to begin their cutting cycle in the face of what looks like a fairly strong economy with record asset prices. What we haven't mentioned is the inherently dovish bias that has underpinned Central Banks in the post 2008 era. While due respect has in more recent been given to the need to maintain price stability, one does get the sense that when push comes to shove, preserving risk asset valuations is paramount. There is simply too much debt to be rolled and balance sheet capacity (or liquidity) is fundamental in keeping the refinancing engine going. Maybe this is the strongest reason of all.

Reasons to be Cautious

Structural Inflation - A number of factors have broadly coalesced in the post COVID period which we think can point to higher inflation going forward - or at the very least provide a floor to how low inflation can go. Geopolitics is one area of concern, with the likelihood of frostier relations between the US and China on the cards resulting in higher tariffs which should, ceteris parabis, prove inflationary (or at the very least not deflationary). Allied to this is the continued reconfiguration of global supply chains (friend-shoring) which has the real potential to add higher costs also. The prospect of all-out war in the Middle East cannot be ignored and the likely impact this may have on the oil price not to mention the potential disruption to global trade and the knock on to other input prices.



Source: Bloomberg as at 30/08/24

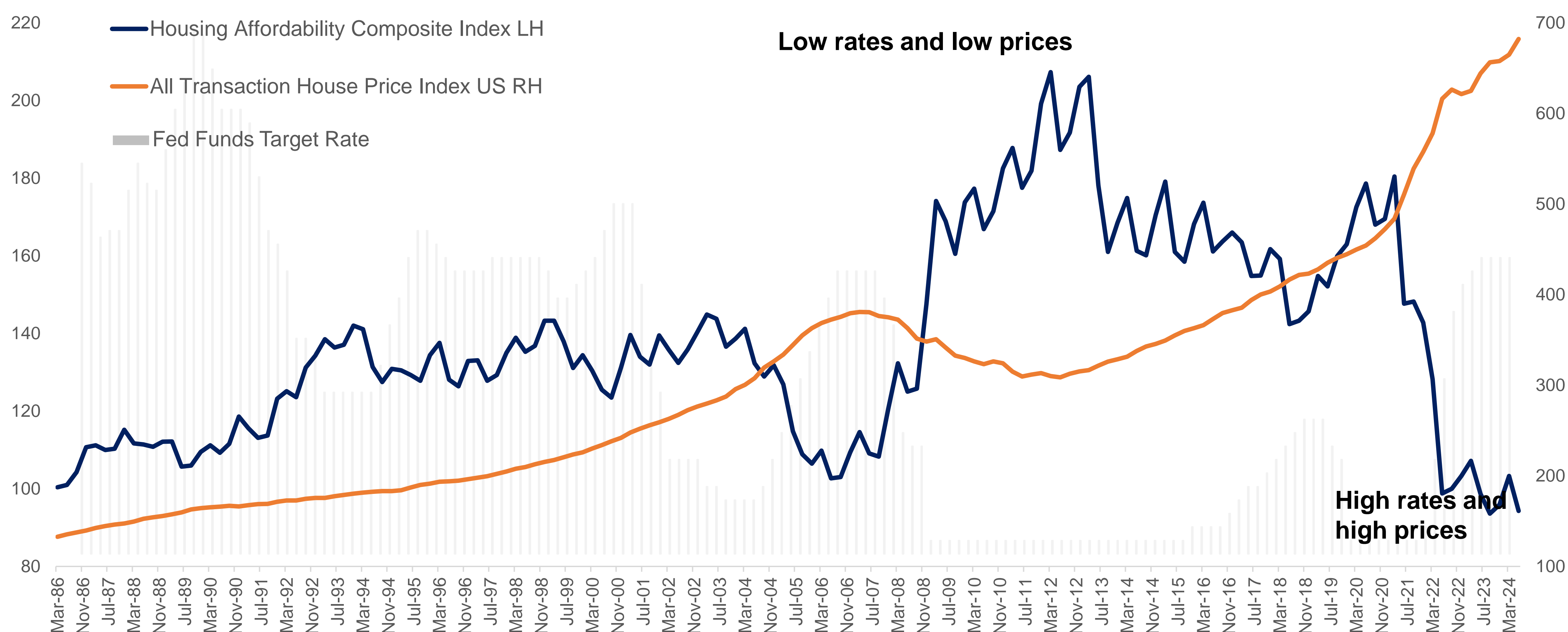


Source: BLS as at 31/12/21

Another of the structural inflationary forces to reveal itself during the COVID period was the impact labour shortages on inflation. While the economy has recovered from the extremes of 2022 - in no small part from increased immigration - with aging populations, declining fertility rates and a political backdrop that is not welcoming of more foreign entrants to the workforce, the availability of labour (or lack thereof) has the capacity to prove inflationary moving forward. The great AI worker displacement may in time prove a counterbalance to this however that may create its own problematic dynamic.

Fiscal dominance is likely to be a feature of the new economic paradigm moving forward (witness Mario Draghi's plea to the powers that be in Europe). There are lots of open questions in relation to this however the general theory would posit that this approach tends to come at generating growth from the bottom up (antithesis to the trickle-down wealth effect of Monetary dominance) which on the margin can be inflationary – 2020's fiscal helicopter drop was an extreme example of this.

Asset Prices - Perhaps the greatest criticism of the Fed's recent actions comes from the fact that the Fed are easing into an economy that is on the face of it pretty robust and with financial conditions at near record levels of looseness. While many don't seem overly perturbed about it, there is a danger that asset bubbles are inflated even further which can cause real financial stability concerns down the line. In terms of the real-world, housing is already at the least affordable levels in history. While cutting interest rates may, at the margin, see a pick-up in some mortgage refinancing and bring in a few new buyers, rates will need to come down a lot farther than they have currently to meaningfully move the needle. It's also worth pointing out that mortgage rates are priced off the 30yr US Treasury yield which already encapsulates 100bps+ of rate cuts over the next 12 months.

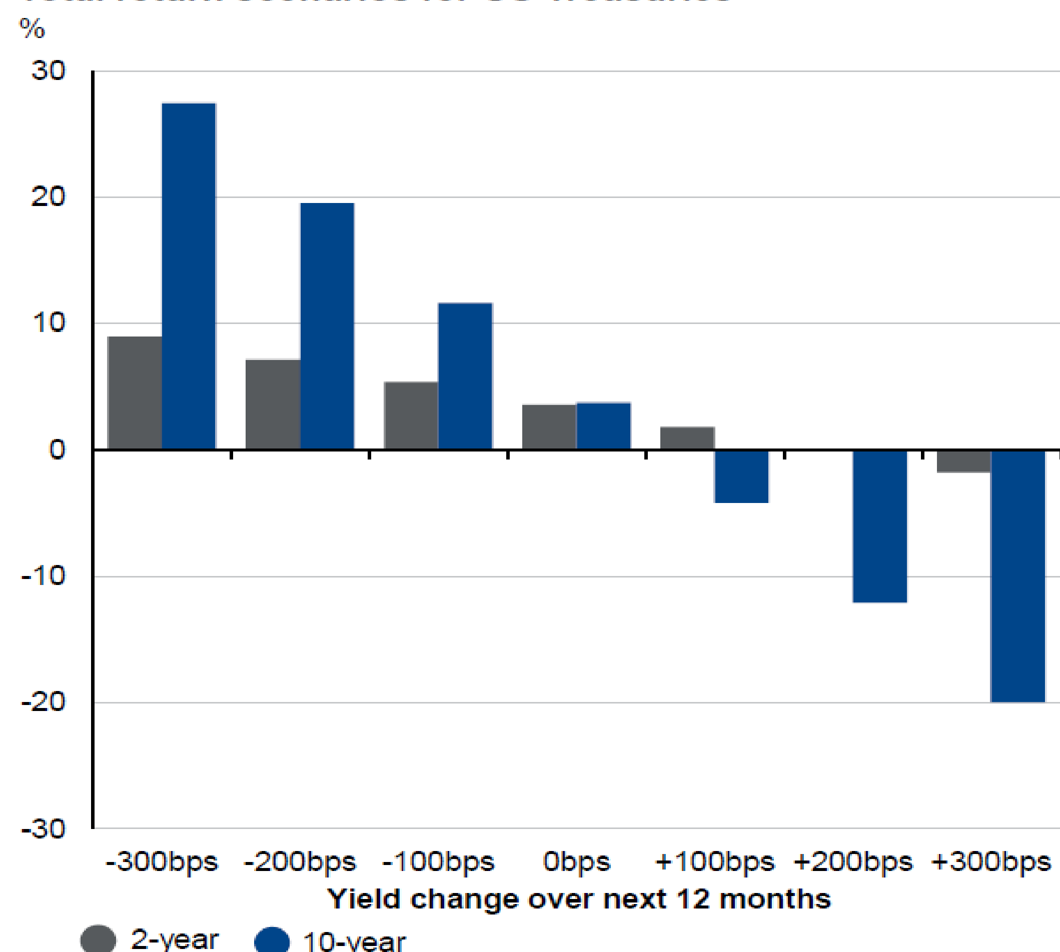


Source: Bloomberg as at 30/06/24

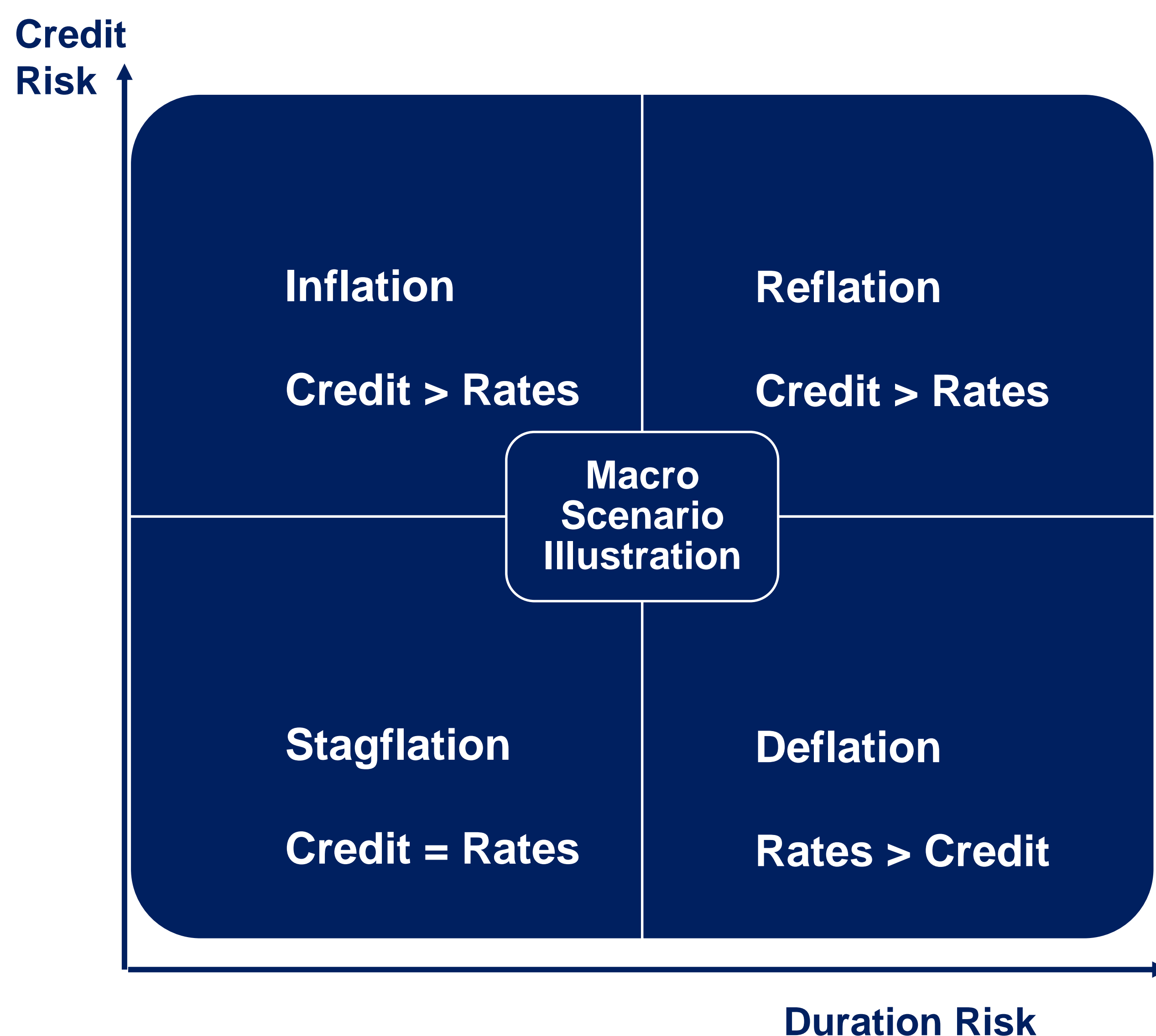
Fiscal Concerns - While we highlighted above the benefits that lower interest rates could have on the growing US interest burden, there is a strong counter argument that needs to be taken into account. Namely the potential impact that cutting interest rates into a "strong" economy can have on the long end of the US yield curve. With the US Treasury issuance calendar already bloated, and in the absence of an immediate source of liquidity in the form of the Fed Reverse Repo Programme, absent recessionary/deflationary dynamics the ease with which the Treasury can find buyers for the additional debt at favourable yields does come into question. There is no doubt of course that were the US to experience a Liz Truss moment the Fed would be in with a liquidity bazooka in the blink of eye, however longer-term debt sustainability would likely require something more substantial to force yields down (financial repression?).

So What?

Unsurprisingly financial markets have taken an optimistic slant on recent developments at the Federal Reserve. This means that financial conditions remain exceptionally loose, equity market valuations remain exceptionally rich and credit spreads remain exceptionally tight. The danger, we are afraid to say, is that any economic outcome that is not of a goldilocks variety is likely negative for risk assets. If the Fed are indeed justified in cutting aggressively, there is a good chance they are late to the party and some form of recession needs to priced into risk assets (currently not the case). If on the other hand the economy keeps chugging along, the likelihood that inflation remains sufficiently under control for the Fed to keep cutting is in our view very low. Higher for longer will need to be priced in once more. It's hard to make a call on which outcome would be more appealing for risk assets and perhaps not very useful to speculate. The good news from a bond perspective is this: 1.) Higher yields mean that in a contractionary growth environment there is real scope for bonds to do their job in diversifying a portfolio with meaningful upside potential from falling interest rates. 2.) Higher yields also limit the potential for losses in the event of stickier inflation with positive convexity tilting the risk reward in favour of bonds 3.) While a selloff in long end yields is not something one wants to be exposed to, a more inflationary environment can keep front end rates elevated providing good carry for investors. Additionally, it perhaps goes without saying that with credit spreads at cyclical tights we don't see this lasting in either the recessionary or inflationary scenario.



Source: JP Morgan as at 30/09/24



As a final thought, it is worth mentioning that Captain Kirk managed to overcome the Kobayashi Moru simulation by re-programming the test. Might the AI revolution similarly change the rules of the game to the extent that a productivity boom will lead to higher growth and lower inflation? Perhaps, although we might be best to leave the Science Fiction for another day.

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